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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1933

No. 11

CENTRAL KENTUCKY NATURAL GAS COMPANY,
APPELLANT,

v.

RAILROAD COMMISSION OF KENTUCKY ET AL.,
APPELLEES.

SUMMARY AND REPLY BRIEF FOR APPELLANT

We believe the Court will be aided by a summary statement of the facts, points and argument for appellant. A reply to the additional brief recently filed by the City, and to the brief just filed on behalf of Mrs. Hignight and others, additional appellees, may also be helpful.

Introduction

We designate herein:

The appellant, Central Kentucky Natural Gas Company, as "Company."

The Railroad Commission of Kentucky as "Commission."

The City of Lexington as "City."

Mrs. Hignight and others as "additional appellees."

United Fuel Gas Company as "United Fuel."

The additional supply of gas required by the Franchise Contract to be furnished through a second pipe line and contracted for with Petroleum Exploration, a West Virginia Corporation, as "the Owsley County gas."

Statement of Facts

The Company is a Kentucky Corporation organized in 1905.

The City is a municipal corporation of Kentucky.

The Company acquired twenty year franchise contracts to furnish natural gas in the City, and also in the Cities of Winchester and Mt. Sterling, to the east of Lexington, in 1905, and began to furnish gas from its Menifee field in 1906. These franchises expired in September, 1925. Prolonged negotiations ensued with the City over the terms of a new franchise. The main points of controversy related to the service and the rates. The Company had not been able to deliver through its ten inch transmission line gas in sufficient quantities to meet peak demands. The City was demanding an additional supply from a new field through a second line.

The Petroleum Exploration had developed a considerable gas field in Owsley County, Kentucky, about sixty miles from Lexington. An offer by it to deliver gas from this field to the Company at Lexington at 40 cents per M. c. f. was made, and this fact was communicated to the City. The Company proposed to the City that it would contract for an adequate supply of this gas if assured of a compensatory rate for the additional expense incurred and service furnished.

The terms of a franchise ordinance were finally agreed upon, and on January 28, 1927 the present franchise ordinance was passed. On February 25, 1927 a contract was entered into between the Company and the City under the

terms of this ordinance. The franchise contract required the Company to furnish the Owsley County gas through a second line within a limited time.

Since no agreement could be reached on the rates for the required service, the franchise contract merely provided for reasonable rates; that the Company should immediately promulgate the rates proposed to be charged; and for the determination by the Commission or Court to which the controversy might be taken of the reasonableness of such promulgated rates.

Pending the fixing of rates by the Commission or Court the franchise contract provided for a rate of 60 cents for the service contracted for, 10 cents thereof to be impounded and the impounded fund distributed according to the rates finally fixed by the Commission or Court.

Immediately following the making of the franchise contract the Company entered into formal contract with Petroleum Exploration under which it agreed to purchase, and the Petroleum Exploration agreed to deliver at Lexington, a minimum annual quantity of 750,000,000 cubic feet of gas at 40 cents per M. c. f. This contract does not expire until February 20, 1947. It covers the same period as the Franchise Contract.

The Company promulgated a schedule of rates which it proposed to charge, averaging 60 cents per M. c. f.; and the City filed its complaint with the Commission attacking these rates.

The Company began furnishing the Owsley County gas the latter part of November, 1927, and the agreed temporary rate of 60 cents went into effect on December 1, 1927.

By reason of the time necessary to enable Ford, Bacon & Davis, Inc., to make an inventory and determine the reproduction cost new less deterioration of the Company's prop-

erty, to investigate the operating records of the Company, and to prepare the necessary exhibits, it was not until March, 1928, that the Company introduced its evidence. The testimony for the Company was then transcribed in order to give the City and its witnesses an opportunity to examine same and prepare inventories and make valuations, and to prepare for the cross-examination of the Company's witnesses. In December, 1928, the witnesses for the Company were cross-examined; and in April, 1929 the City introduced its witnesses and evidence. The testimony for the City was then transcribed and in June, 1929 the witnesses for the City were cross-examined, rebuttal evidence offered by the Company, and hearings concluded.

On October 9, 1929 the Commission entered its order fixing a 45 cent rate for the contracted service. The Commission applied this rate to the contract date, February 25, 1927, and over the intervening period.

Prior to the entry of the rate order the Company requested the Commission to make findings of fact. Objection thereto was made by the City and the Commission refused to make any findings whatever.

The Company filed this suit on October 19, 1929 seeking to enjoin the enforcement of the Commission rate as confiscatory, alleged the reasonableness of its own rates, and asked that the impounded fund be awarded to it.

The parties agreed to submit the case on the Commission record. An order to that effect was entered by the Statutory Court. The issue thus submitted was the validity of the Commission rate for the contracted service as of the date of the order (October 9, 1929) and as applied over the period from and after the ffanchise contract date (February 25, 1927).

The Court below filed its opinion on July 11, 1932 holding the Commission rate was inadequate and confiscatory.

It determined the rate base, rate of return, and allowances for amortization and extraordinary maintenance; and found that the net income produced in 1927 under the 50 cent rate (60 cents in December) was sufficient to provide for operating expenses, allowances for amortization and extraordinary maintenance, and yield the Company, in a normal year, a return of 7 per cent.

The Court overlooked the fact that under the 50 cent temporary rate collected in 1927 (60 cents in December) the cost of the purchased Owsley County gas (amounting to $300,000.00 annually) was not reflected in the operating expenses except that portion purchased in December, 1927 (about 15 per cent of the minimum annual requirement) and therefore the net income for that year was not typical or representative of a normal year.

The Company filed a petition to modify and correct the decision by making proper allowance for the additional cost incurred in rendering the service by allowing for the full cost of the Owsley County gas, and by making certain other adjustments shown by the record to be necessary in determining net income for a normal year—particularly temperature and income tax adjustments.

The Court refused to modify its opinion on the stated ground that the parties had requested it to determine the rate base as of December 31, 1926, and to determine the validity of the Commission rate of 45 cents as applied to that date, and that a determination of income on the basis of the contracted service would necessitate a redetermination of the value of the property as of a date or dates subsequent to December 31, 1926.

The Court found that the Company was entitled to a permanent injunction against the Commission rate, but only if the Company would agree to accept the 50 cent rate considered by it to be reasonable, and gave the Company its

election. The Company declined to acquiesce in the offered 50 cent rate.

On September 22, 1932 decree was entered fixing the rate base, allowance for amortization, rate of return, and holding the Commission rate of 45 cents invalid; but because the Company had declined to acquiesce in a 50 cent rate, the Court refused to grant a permanent injunction against the Commission's order. The decree directed a distribution of the impounded fund on the basis of a 50 cent rate as reasonable, ordered the Company to pay the costs, and further directed the Company to file a statement of the amounts collected from its consumers between the Commission rate of 45 cents and the 50 cent temporary rate during the period of its collection, and also of the amounts collected between 50 cents and the 60 cent temporary rate.

The Company filed a petition for rehearing which was denied.

Errors Relied Upon

The errors relied upon are:

1. The Court's failure to take into consideration the cost of the Owsley County gas in estimating the Company's operating expenses as for a normal year.

2. In determining net income for a normal year the Court should have made the necessary adjustments for average temperatures as affecting the quantity (and cost) of gas purchased and sold; and for the increased income tax.

3. The Court's refusal to determine the validity of the Commission rate as applied to the service contracted for, and over the period to which the Commission applied its rate.

4. The finding that a 50 cent rate for the contracted service would produce a 7 per cent return.

5. The finding that a 7 per cent return is fair.

6. The refusal to find the Company's promulgated rates reasonable.

7. The refusal to find that a flat rate is discriminatory and confiscatory, and that the Company has the contract right as well as the statutory right to fix its own rates both as to form and amount, provided that they be just and reasonable.

8. The refusal of the Court to grant a permanent injunction against the enforcement of the Commission rate which it found to be confiscatory.

9. The refusal of the Court to enter a final order fixing reasonable rates for the service required under the contract and to order a distribution of the impounded fund on that basis.

10. The order directing the Company to pay the costs, contrary to the franchise contract.

Summary of Argument

I.

The Court erred in assuming that the 1927 expenses under the 50 cent temporary rate (60 cents in December) fairly represented the Company's operating expenses in a normal year for the contracted service.

The Company collected the temporary rate of 50 cents provided for in the franchise contract until the additional service contracted for began, that is, until it was furnishing the Owsley County gas through the second line. This service began in November, 1927, and the agreed temporary rate of 60 cents went into effect December 1, 1927.

The Court found that the net income in 1927 under the

50 cent rate (60 cents in December) was almost enough to produce a 7 per cent return on the rate base, and concluded that a 50 cent rate for the contracted service would in a normal year (1927 being warmer than usual) produce a 7 per cent return. In adopting the income for 1927 under the 50 cent rate (60 cents in December) as typical for a normal year the Court overlooked the fact that the 1927 expenses did not reflect the added cost incurred by the Company on account of the purchase of a minimum of 750,000,000 cubic feet of gas at 40 cents, amounting to a fixed annual expense of $300,000, required by the franchise contract.

As delivery of this gas did not begin until November, 1927, no expense for it appeared in the item "Cost of Gas" for 1927 until the month of December. The cost of the Owsley County gas purchased in December, 1927 amounted to $47,485.34 as compared with the fixed annual minimum cost of $300,000 therefor.

The City has always and unequivocally admitted that full allowance must be made for this fixed annual expense, on the ground that the contract under which this gas was purchased was entered into pursuant to the absolute requirement of the franchise contract.

The mistake or oversight of the Court conclusively appears on the face of its opinion. The Court says (R. 89):

> "This result may be reasonably accepted, * * *, as a fair *prophecy* of a minimum return during a normal year by the application of a 50 cent rate."

A prophecy looks to the future and the necessary implication is that the Court was endeavoring to determine a reasonable rate for the contracted service when it found that the 50 cent rate would—

> "* * * permit the deduction of the necessary expenses incurred in ordinary maintenance * * * an

> annual reserve to cover extraordinary maintenance and repairs. * * * the deduction of all taxes, including the Federal income tax. * * * allowances in the meantime of adequate amounts *for necessary expenses* * * *."

Had the Court intended to exclude the cost of the Owsley County gas as a "necessary expense" it would certainly have said so, especially as the City expressly admitted such purchased gas to be a necessary expense. The testimony, exhibits, and briefs of both City and Company allowed for the full annual cost of this gas. The Court did not discuss or even mention the cost of the Owsley County gas. The list of producers furnishing gas is set forth in the 1927 operations, including the Petroleum Exploration contract for the Owsley County gas, and in adopting the expense so manifested the Court necessarily approved of and intended to give full recognition to that contract.

The Court criticized the Company's estimate of return under its proposed rates because the estimate showed a less return under these rates, averaging 60 cents, than the company actually received in 1927 under the 50 cent rate (60 cents in December). The Court said this result was "strange". It did not understand or appreciate that the estimate made proper allowance for the cost of the Owsley County gas which accounted for this result. The Court did not reject the estimate because of such allowance. It would surely have done so had it intended to reject the cost of the Owsley County gas as an operating expense.

As a reason for refusing to correct its mistake the Court said that the parties had requested it to determine the rate base as of December 31, 1926, and to determine the validity of the Commission rate as of that date; and said that a determination of the net income on the basis of the contracted service would necessitate a redetermination of the rate base

as of a later date because that service did not begin until December 1, 1927.

The evidence showed there was no material change in property values between December 31, 1926, and the date of the Commission's order (October 9, 1929). Furthermore, since the contract left open the question of reasonable rates from the contract date, February 25, 1927, it was obviously necessary that the rate base be determined as of that date, as a basis for distributing the fund which began to be impounded on that date. As there was no subsequent material change in the rate base the parties were willing to accept for all purposes of the case the value of the property as of December 31, 1926.

A determination of net income on the basis of the cost of the additional service, and which both parties have at all times agreed must be allowed in operating expenses, had nothing whatever to do with the rate base and service which began on December 1, 1927, and did not necessitate a redetermination of the rate base as of that date because operating expenses do not affect values.

The reason assigned for refusing to modify the opinion is inconsistent with the Court's own action in adopting as the rate base the sale price of the Company's capital stock in January, 1928, which was subsequent to the beginning of the service contracted for.

Finally, the refusal of the Court to determine net income and a reasonable rate on the basis of the added cost for the contracted service was a refusal to decide the very issue created by the franchise contract and submitted for decision. This was the precise question submitted to and decided by the Commission, as clearly appears from the Commission's order. It was the theory of the City whose counsel prepared that order at the request of the Commission. The order was entered on October 9, 1929, and the 45 cent rate was fixed as *a future rate for the con-*

tracted service which the Company had been furnishing since December 1, 1927. The very language of the order in its reference to the 60 cent temporary rate proves conclusively that the Commission intended to fix a rate under the 60 cent conditions, that is, the service contracted for. It was compulsory on the Commission to do this. The Commission applied the rate to the contract date and over the intervening period, without making any distinction between the service which the Company rendered under the old operating conditions for a period of nine months and the service contracted for which commenced December 1, 1927, when the company began furnishing the Owsley County gas through the second line.

The rate order does not even refer to the 50 cent temporary rate which was collected until the additional service began. This omission can be explained only on one of three grounds, either (1) the Commission overlooked the question of fixing a rate for the period of the 50 cent temporary rate, or (2) the Commission regarded the question of a different rate for the 50 cent period as of negligible importance, or (3) the Commission construed the contract as requiring the fixation of a rate for the contracted service as of the date of the rate order and under the 60 cent conditions, and as requiring the application of such rate to the contract date and the intervening period without regard fo the operating conditions existing during the collection of the 50 cent rate.

The last reason furnishes the only rational interpretation of the Commission's understanding of the franchise contract. It was the interpretation placed on the agreement by counsel for the City. It was the interpretation placed on the contract by counsel for the Company, who wrote in its brief filed in the Court below (and filed here by the City) that—

"* * * the rates and charges as finally fixed by the Commission or Court should apply as of the contract date, * * *" (Company's Reply Brief, p. 16).

In determining net income for a normal year the Court should also have made the necessary adjustments based on average temperatures as affecting the quantity and cost of gas purchased and sold, and for the increased income tax. This question is discussed in detail in the Company's main brief at pages 41-46. The principle involved is well illustrated in the recent Los Angeles case (289 U. S. 287).

On the above grounds the Company contends that the reason assigned by the Court for refusing to modify its opinion and determine net income on the basis of operating expenses for the contracted service is unsound.

II.

50 Cent Rate for Gas Will not Produce 7% Return

It is not denied that a 50 cent rate for gas for the contracted service would not produce a 7 per cent return (after making proper allowance for the cost of gas purchased by the Company). The calculations set forth in the Company's main brief demonstrate that a 50 cent rate would produce a return of only 2.6 per cent.

III.

The Company's Rates are Reasonable

For the contracted service the Company's schedule of rates, averaging 60 cents, would produce a return of only 5.42 per cent. The company's estimate of return under this schedule has been worked out with painstaking completeness. No error in method or as to a single detail has been pointed out. The only criticism offered by the City is

that it is merely an estimate. The city presented no estimate.

The franchise contract gives the Company the right to fix its own rate structure. Such schedule may include a minimum or service charge, higher rates for smaller quantities of gas and lower rates for larger quantities. This contract right is also a statutory right. The Company should not be required to operate under a flat rate, which form of rate necessarily results in discrimination among consumers.

IV.

The Fair Return

The matter of a proper rate of return is a question of fact, depending on the evidence, and can not be determined as a matter of judicial knowledge. The evidence for the Company was that a 10 per cent rate of return was fair. The City offered no evidence on the subject. The decree fixing a 7 per cent return is contrary to the only evidence in the record.

V.

Permanent Injunction Should Have Been Granted

Although finding the Commission rate of 45 cents confiscatory the Court refused to grant an injunction restraining its enforcement unless the Company accepted a 50 cent rate. The Court attempted to justify its action under the equitable doctrine requiring a plaintiff asking equity to do equity. This doctrine has no application. Having sustained the burden of proving the Commission rate confiscatory the Company was entitled to the permanent injunction as a matter of right.

The condition imposed required the Company to surrender its lawful right of appeal and was therefore wrong as a matter of law and an abuse of judicial discretion, even

if the Court had the right to exercise any discretion in the matter. The franchise contract carefully fixed and protected the mutual equities of the parties. There was no reason therefore for employing the equitable doctrine, and its application deprived the Company of its contract rights. The Court should have granted the injunction and entered a final order either sustaining the Company's promulgated rates or fixing just and reasonable rates for the contracted service.

Aside from the franchise contract (which both parties agree makes the question of reasonable rates a judicial one), this subject matter is a judicial question by virtue of the impounded fund which must be distributed on the basis of reasonable rates or compensation for the service rendered.

The determination of just and reasonable rates by this Court or a judgment sustaining the Company's rates would not be a legislative act fixing a future rate. It would be the fixing of rates as of the date of the Commission order and for a past service. The application of the rates fixed to the ensuing two year period is the result of the franchise contract.

VI.

It Was Error to Order the Company to Pay the Costs

The franchise contract provides that all Court costs shall be paid equally by the Company and the City. It was therefore error for the Court to order the Company to pay all costs. The City concedes this error.

VII.

Response to City's Brief

Our refusal to follow through the various contentions and erroneous calculations contained in the City's main brief seems to be regarded by counsel as a confession of

weakness, and our criticism of the City's brief as containing incorrect statements is rather warmly protested (City Reply Brief, p. 37). Continued declination on our part to point out some of the errors of counsel in the use of figures and in statements of fact might be misconstrued, and we shall attempt to justify our previous observations.

Treatment of the 1926 Operations

We go first to the City's reply brief. Counsel express amazement at having overlooked a matter now found to be so conclusive as to really end the argument. This new point is given front-row position in the first four pages.

(*a*) They arrive at the "actual" result of 1926 operations, as if under a 45 cent rate, by adding the amounts of gas sold under the 40 cent and 50 cent rates and dividing the total by two. This amount is then added to the net income under the 40 cent rate (R. 116*a*, last figure in next to the last column) after deducting the Court's allowances for amortization and extraordinary maintenance, and the result ($196,262) is presented as the "actual" income for 1926 under a 45 cent rate.

No allowance is made for the added cost of gas under a 45 cent rate, and the larger income tax under such rate. They should have taken the totals of income under the 40 cent rate and the 50 cent rate (the last figures in the last two columns of page 116*a*) to-wit, $196,232, and $278,254, or $474,486, and divided this figure by two, making $237,243. This would be the correct revenue under a 45 cent rate for amortization, etc., based on 1926 operations. Deducting the total of the Court's allowance, $75,263, would give as net income for return $161,980 instead of the City's figure of $186,262. This income would produce a return of approximately 7.3 per cent on the Court's rate base and not a return of 8½ per cent as stated by the City. How-

ever, the exclusive use of 1926 operations is basically wrong as shown herein.

(*b*) The year 1926 is declared to be "the agreed year," and counsel treat this point as if the Court below had expressly based its findings of income and reasonable rate on the actual operations for 1926.

Counsel do not indicate who were the parties to the assumed arrangement under which 1926 became "the agreed year," or point to any record evidence of the existence of any such agreement. The Court certainly did not so understand the matter as it discussed the 1926 operations, both under the 40 cent rate and under the 50 cent rate, and rejected the actual operations for 1926 as not affording a fair test, because the temperatures were much lower than the average (R. 88-89). No Court or Commission could or would even think of fixing a future rate on the basis of one year's operations.

(*c*) It is stated that the Court found "a net income available for return in 1926 of $144,574." This was the actual net income which the Court found for 1927 under the temporary rate of 50 cents (60 cents in December). Perhaps the use of "1926" is a misprint in counsel's brief, but under that view the use of the figures in connection with 1926 operations would be without point.

(*d*) Although having no bearing on the point attempted to be made, counsel compare (p. 3) the property valuation claimed by the appellant in its Bill of Complaint, to-wit, $6,340,895, with the Court's rate base of $2,198,107. The comparison is made as though the two amounts were properly comparable, and for the obvious purpose of impressing this Court with the idea that appellant had made excessive valuation claims. The figures are not comparable. The $2,198,107 includes only the allocated portion of appellant's property, plus the value assigned to the Lexing-

ton Utilities property. The value of appellant's property fixed by the Court was $2,880,000, and for the Lexington Utilities property $611,227, a total of $3,491,227. A valuation of $2,000,000 was placed by the Company's witnesses on the Menifee field for storage use and as a gas holder for emergency purposes. The Court rejected this claim (R. 83). Omitting this single item the value given to the two properties by the Court below is not greatly less than claimed by the Company. Had the Court in adopting the sale price as the best evidence of value added the Company's indebtedness over its deductible assets, amounting to more than $400,000, as manifested by the balance sheet (R. 215), the total value would have been $3,891,227, as against the Ford, Bacon & Davis, Inc., valuation of $4,280,627 (Company Brief in District Court, pp. 19-22).

It is difficult to attribute counsel's misuse of the above figures entirely to unconscious error.

The record shows conclusively that it is impossible for the Company to earn an adequate return on the Court valuation under its schedule of rates averaging 60 cents. For the Company to contend for a higher rate base would have no compensating advantage, even if successful.

The Amortization Allowance

Still denying the right of the City to attack the allowances for amortization and extraordinary maintenance (it not having appealed), we will reply to its contentions relative to this subject matter. The City put into the record certain testimony offered by it claimed to have a bearing on the annual allowance which the Company is entitled to for amortization. It presented no estimate or proof of what the allowance therefor should be. It claims the right to attack the Court's findings of fact under the doctrine of the *Langnes* case (282 U. S.

531) and comfortably reflects that if the Company had any evidence on the subject and did not bring it here, this is the fault and misfortune of the Company. This Court was asked to consider the amortization allowance without having before it any of the evidence on the basis of which the allowance was made. The Court below gave no weight whatever to the Beckner estimate of reserves, nor to the fact that appellant is now a subsidiary of Columbia Gas & Electric Corporation.

Counsel for the City state with specific definiteness that there was no evidence justifying any allowances whatever for amortization. They comment thus on the Court's findings (Reply Brief, p. 20):

> "It allowed it without even speculation behind the allowance. It just allowed it.
>
> * * * * * * *
>
> *And it (the appellant) introduced no word, no expert, no hint, to justify the allowance. Literally, absolutely, exactly, it introduced not one word* of proof about gas supplies. * * * *it may be that it dared not submit the facts.*"

Apparently conceiving a weakness in the City's contention on amortization without having the Company's evidence on the subject before this Court, counsel for the additional appellees have caused to be certified the testimony of the Company's expert witness, Mr. Kimball (Addition to Transcript, pp. 10-14, 19, 22-35, 37-45).

The addition to the printed record shows that the amount claimed by the Company for amortization and allowed only in part by the Court is predicated on the following grounds:

1. The complete exhaustion of the Production System property (less salvage) including—

(*a*) The Menifee field gas wells, field lines, etc. (R. 40).

(*b*) The Red Bush field, gas wells, field lines, etc. (R. 40).

2. The termination of the useful life of the entire transmission system (less salvage) (R. 40).

3. The termination of the useful life of the Lexington suburban distribution property (owned by the Company) and other distribution system properties (less salvage) (R. 42).

4. The amortization of the construction overheads and intangible capital, as to which there could be no salvage (R. 45).

5. The termination of the useful life of the distribution system in the City of Lexington for natural gas uses (less salvage) (R. 37, 38).

6. The probable exhaustion of the supplies of the United Fuel in twenty years (R. 11-12, 24, 25, 37). A fact of common knowledge based on judicial decision. *United Fuel Gas Co.* v. *Railroad Commission,* 13 F. (2d) 510, 523; 278 U. S. 300, 312.

7. The exhaustion of the supplies of all other producers now furnishing gas to the appellant (R. 37-38).

8. The impossibility of selling the securities of a natural gas enterprise on the basis of amortization over a longer period than 20 years (R. 37).

9. The termination of the franchise contract at the end of 20 years and with it all right to continue the service (R. 38). A ground sustained by the Kentucky Court of Appeals in *Johnson County Gas Co.* v. *Stafford,* 198 Ky. 208, 248 S. W. 515. We ask the Court to read at this point the

discussion on this subject in the Company's brief filed in the Court below (filed here by the City) at pages 43 to 49.

The franchise contract provides that the rates finally fixed shall continue for a period of two years before either side may move for a modification (R. 34, Sec. 7). It will thus be seen that any error in the allowance for amortization may be remedied after a very short interval.

Mr. Yunker testified as a matter of personal knowledge (based on long experience with the gas production in this territory) concerning Beckner's theoretical reserves, county by county. He eliminated many counties entirely and large portions of other counties in which the non-existence of gas had been proved by actual drilling (R. 27). Subtracting his eliminations would leave a balance of reserves that would be exhausted in about 12 years on the then rate of actual gas withdrawals approximating 30 billion cubic feet per annum (R. 30). The Beckner estimate of one trillion cubic feet, even assuming its actual existence and that it could be economically recovered, would last only 33 years on the basis of annual withdrawals of 30 billion. Furthermore, Yunker testified that the reserves estimated by Beckner in a large tier of counties, even if existent and commercially available, could not be economically delivered through the Company's present transmission lines (R. 30).

The Beckner estimate contains many absurdities. One illustration will suffice. His estimate for Boyd County is 14,580,000 M. c. f., indicating 100 thousand cubic feet per acre (R. 203). This assumes 145,800 acres in Boyd County. The Court will take judicial knowledge of the fact that Boyd County contains 159 square miles, or only 101,760 acres.

In the 30 counties he estimates 368,142,600 M. c. f. at 100 thousand cubic feet per acre (R. 203); this would indicate

3,681,426 acres. If a well were drilled to each 100 acres it would necessitate 36,814 wells. Such wells would vary in cost with depth and location. If the average cost per well were only $5,000 the cost of the gas at the well would be 50 cents per thousand cubic feet. This cost would not include anything for the pipe lines necessary to bring the gas to appellant's transmission line, nothing for compressor stations to transport the gas, and no operating cost for either the wells, the pipe lines, or compressor stations.

Another example is the "Middle Mississippian, 10 thousand" (R. 203). In the table he estimates reserves in 16 counties from this structure. With a reserve of 10 thousand cubic feet per acre one well to 100 acres would produce 1,000 M. c. f. If the entire amount of gas from this well were sold at 50 cents per thousand it would bring $500. A well could not be drilled for any such sum, to say nothing of the additional investment required and necessary operating costs during the time such well was producing. Is it any wonder the Court disregarded the Beckner estimate of gas reserves in fixing its allowance for the amortization of appellant's property?

The amortization allowance is designed to return to the stockholders their investment in the property by the time of the termination of the enterprise. As was said by the United States District Court for the Eastern District of Kentucky in *United Fuel Gas Co.* v. *Railway Commission*, 13 F. (2d), 510, 518, affirmed in 278 U. S. 300:

> "Because of the exhaustible character of his product, the natural gas operator is entitled to receive, through the returns charged, not only his actual expenditures of operation and depreciation charges in the sense of such sum as will keep his plant at 100 per cent operating efficiency, but he is also entitled to such rates as will refund to him his entire capital

> investment within the life of the business. When the field is finally exhausted, as it must be, the reserve for depletion, or amortization reserve, should be sufficient to repay to the investor 100 per cent of the original investment. * * * The right to this amortization or depletion reserve, or the right of the company to earn such sum as would reimburse the investor for his original capital investment at the termination of the business is universally recognized. This is in addition to what is ordinarily denominated a charge for depreciation or deterioration by use."

In re Baker Natural Gas Utility, P. U. R. 1921E, 609, 626, the Public Service Commission of Montana said:

> "Depreciation and depletion in a utility of this nature are an amortization charge. Were this not so the stockholders would lose their investment and be obliged to content themselves with the interest they had received thereon. Unlike other utilities operating in theory at least, in perpetuity, with the recurring levy for renewals and replacements preserving the investment intact as a going concern, the natural gas utility suddenly ceases on the exhaustion of its natural stores, and its appliances are rendered useless for their original uses. Unless there has been accumulated a money reserve in a depreciation and depletion fund equal to the investment the stockholders must pocket their losses, and, under regulation, this means an end of natural gas development for public uses."

An analogy for the allowance of amortization in natural gas rate cases is found in the Federal Income Tax Act of 1916 (and later enactments) authorizing deductions for the exhaustion of mining property (coal, copper, gas, iron ore, oil, etc.), in arriving at taxable income.

In *United States* v. *Ludey*, 274 U. S. 295, 300-302, the Court said:

"We are of the opinion that the revenue acts should be construed as requiring deductions for both depreciation and depletion when determining the original cost of oil properties sold. * * *.

The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken."

In *Hammond* v. *Public Service Commission*, — Ore. —, 189 Pac. 639, 9 A. L. R. 1223, the Supreme Court of Oregon held that a railroad used to remove the timber to be cut from a tract of land was entitled to charge rates which would provide for the amortization of its cost as well as yield a fair return on the value of the property. In the opinion the Court said:

"* * * the company is entitled to such rates as will fairly compensate it for the service rendered, and for the depreciation of its plants employed in such service, even though it reaches the vanishing point. In other words, the company ought to be allowed to come out even, in an undertaking which may reasonably be expected to exhaust itself, and, besides quitting whole, to receive a fair compensation for its services. The carrier ought not to be compelled to sacrifice its plant, and be content merely with compensation amounting only to interest on its value. To ignore this principle would be to violate the constitutional inhibition already quoted. A public service corporation cannot be expected to sacrifice its property for the public good."

The Company's balance sheet as of December 31, 1926, shows on the *asset* side this item (R. 213):

"Less Depreciation to Dec. 31, 1926—$1,456,400.65."

The balance sheet for December 31, 1927, shows on the *liability* side this item (R. 217):

"Renewals, Replacements and Depletion—$1,662,062.69."

Counsel for the City uses these entries as proof of the existence of an actual fund in the above amounts, and on that ground dispute the right to any allowance for amortization (Reply Brief 23-25).

But both Mr. Kimball (R. 225), and Mr. Hightower (R. 237), testified that there was no such fund. The dividend record (Addition to R. 19) shows that over the period of its first franchise, 1906-1926, the Company declared no dividend in 1906, 1907, 1912, 1913, 1914 and 1915; a dividend of 2½ per cent in 1909 and 1911; a dividend of 5 per cent in 1908 and 1910; a dividend of 6 per cent in 1916 to 1926 inclusive. This "depreciation" item has therefore been built up at the sacrifice of an adequate return to the stockholders. A very large part of it obviously represents capital investment. This item in the balance sheet has no bearing whatever on the fair value of the property used and useful in rendering the gas service, and the argument of the City based thereon is predicated on a false premise.

The allowance for amortization in this case is supported by the evidence, and the Court's finding should not be disturbed.

The Amortization Allowance for the Lexington Utilities Distribution Plant

The Company claimed an allowance for amortizing the value of this plant, less a salvage of about 50 per cent. Complaint is made that no allowance whatever should have been made therefor, on two grounds: (1) the appellant does not own this property, and (2) the Lexington Utilities (successor to the old Lexington Gas Company created by private legislative act prior to the adoption of the

present State constitution) has a perpetual gas franchise. We deem the following considerations sufficient answer to this contention:

1. Presumably the rental paid to the Lexington Utilities Company is sufficient to afford an adequate allowance for amortization. Treating the Lexington Utilities property as part of the rate base (found to be more favorable to the consumer) entitles the Company to an allowance for amortization on that property in fixing a rate for its gas service.

2. The Court may take judicial cognizance of the terms of the legislative grant, and the municipal control over the old Lexington Gas Company prescribed thereby (Acts of General Assembly of Kentucky, 1875-76, page 475). The City was given representation on the directorate, and the management was therefore joint. Not since 1905, when the City sold and appellant purchased the franchise for *natural* gas (the use of which was not contemplated when the Lexington Gas Company was given its charter) has there been any joint control, either of the Lexington Gas Company or of its successor, the Lexington Utilities Company.

3. There was no proof offered as to whether the rights under the original grants still existed or had been abandoned. Having failed to present any proof on the subject the City may not now raise this question.

4. Even assuming that the Lexington Utilities Company has the right to continue its occupation of the streets of the City under the original grant to its predecessor after the expiration of the present franchise, some allowance for amortization must be made. The proper amount was a question of fact to be proved as any other fact. The Court's finding is amply justified by the evidence.

The Allowance for Extraordinary Maintenance

In the City's reply brief counsel assert that "not one dollar of this sum is sustainable by the record". The Company's evidence on this subject is now in the record before this Court (Addition to R. 14, 46-50). The necessity for this allowance is therein adequately explained as covering the unusual repairs required to keep the plant in first-class condition. The distinction between an allowance for amortization (to return the capital investment) and an allowance for depreciation or extraordinary maintenance requires no explanation.

The argument of the City here is not consistent with its admission in the Court below where it adopted the Company's allowance for extraordinary maintenance as fair and proper (Carter's Exhibit 8, R. 191, 192), from which we quote:

> "Depression charge, $21,262.00" (R. 191).
>
> • • • • • •
>
> Estimated annual allowance necessary for extraordinary maintenance (See P. 28, Ex. No. 4, F. B. & D.).
>
> | | |
> |---|---|
> | Central Kentucky Natural Gas Company, Inc. | $12,878.00 |
> | Lexington Utilities Company | 8,384.00 |
> | Total | $21,262.00 (R. 192). |

In their brief in the Court below, a copy of which has been filed here with the Company's Reply Brief, counsel for the City said (pp. 38, 40):

> "So Mr. Carter has allowed the Lexington part of the $20,000.00, some $12,878.00 as an annual charge or expense. In the words of Mr. Kimball, that 'takes care of the depreciation.'
>
> • • • • • •

It is submitted that Mr. Carter was right and fair in adopting Mr. Kimball's annual $20,000.00 depreciation charge, * * *."

The Criticism of the Court's Rate Base

Going now to the City's main brief, and passing the question as to its right to attack the Court's findings of value without taking a cross-appeal, we desire to point out some "inexcusable" errors of counsel in their treatment of this subject, both in their computations, and in statements of fact. The City's argument is somewhat scattered. It appears in part at pages 49-51, and in part at pages 93-96. We shall follow the City's arrangement, directing attention first to its conclusion that the Court's rate base is too high by the sum of $440,574 (p. 96). How counsel can justify any argument whatever on value without bringing to this Court the evidence on the subject is beyond our comprehension. They present only alleged totals as if the evidence from which such totals were derived is quite unnecessary.

But passing this difficulty, we come first to *the Jirgal value* (Brief, pp. 50-51). The City has put into the record Jirgal's adjusted historic or book *cost* of the Company's property as of December 31, 1926, amounting to $1,582,974.63 (R. 229), and also his historic or book *cost* as adjusted by him of the Lexington Utilities property as of the same date amounting to $383,152.66 (R. 229). The City did not put into the record the Jirgal *values* as of said date based on 1926 prices. But his value of the Company's property appears in the Court's opinion as $2,653,035 (R. 83), so counsel were obliged to disregard Jirgal's *cost* figure and use his *value* figure for the Company's property in the Lexington district. However, instead of using Jirgal's value of the Lexington Utilities property, they use his cost ($383,-

152). We feel justified in informing the Court that Jirgal's value of the Lexington Utilities property was $552,001. Using the correct figures counsel for the City should have shown as the total for the Jirgal *value* the sum of $2,013,823, instead of $1,844,974 (p. 50). Jirgal's total depreciated by 9.4 per cent (used by the City) would be $1,814,524, instead of $1,671,547 (p. 51).

Counsel also fail to direct attention to the comment of the Court below in its discussion of the Jirgal value. We quote (R. 83):

> "Jirgal found the historic cost (meaning reproduction cost based on historic cost) of the entire plant, to be $2,653,035, *without giving consideration to any going concern value and some other items, such as gas pumped (purchased) and stored in the Menifee field and working capital.*"

If the Kimball figures for going concern value, $248,000 (Addition to R. 44); for stored gas, $409,663 (R. 40); and for working capital, $83,000 (R. 44), be added to the Jirgal *value* of the Company's property, the total would be $3,393,698. Allocating to Lexington 55.1 per cent of this figure gives $1,869,927, as compared with $1,461,822 used by the City. Adding the Jirgal value for the Lexington Utilities property would make his value for the Lexington district $2,421,928, instead of $1,844,974, used by counsel (p. 50). Depreciated on the basis of 9.4 per cent we would have as the final Jirgal value $2,276,661 instead of $1,671,547 used by the City. It will be seen therefore that counsel was in error in stating on page 51 of their brief, relative to their Jirgal value figure, that—

> "To that rate base then, *the only one free and clear of all conjecture,* the only one unhampered by market conditions, we turn *as a sure guide,* and applying the

> figures to the year 1928, we get *definite and exact record*, and not estimated results."

Counsel take Carter's value based on reproduction cost new depreciated by 27.6 per cent instead of 9.4 per cent, add the Kimball intangibles, and present as the Carter value $1,687,897. They add their computed Jirgal value of $1,671,547, and their "purchase price" valuation of $1,913,157, and obtain an average value on this basis of $1,757,533 (p. 96). We have shown the error in the figures adopted for the Jirgal value. The purchase price is also wrongly stated. Referring to the Carter valuation the Court below said (R. 83):

> "Carter left out altogether some of the items that should be considered in arriving at a fair reproduction cost * * *."

The Court rejected the Carter valuations in toto.

Counsel for the City criticize the Kimball valuation on the ground that his testimony was hearsay. This objection was made in the City's brief in the Court below (which is filed here) at pages 11-17. The argument in the City's main brief appears on pages 93-95, and counsel now seek to have this Court sustain their contention. They have apparently overlooked Supreme Court Rule No. 16. The record does not show that any objection was made or exception reserved to the admission or consideration of the Kimball evidence. It is thus apparent that even if it were open to the City to attack the Court's rate base, the figures offered by it are erroneous.

The City's brief (pp. 51-52) presents figures claimed to show a net income under a 45 cent rate based on 1926 conditions of $156,615, or a return of 9.4 per cent on the alleged Jirgal value of $1,671,547. However, as the com-

puted Jirgal value figure used by the City is grossly erroneous the calculation and deduction made are unimportant.

The United Fuel Gas

The Owsley County gas and the United Fuel gas are treated as if they were opposite flanges on a revolving door, and that when one was pushed in the other was automatically pushed out. But there is no relation whatever between the two. The Owsley County gas (delivery of which began in November, 1927) was purchased pursuant to the Franchise Contract obligation, and for that reason alone the cost of the gas must be included as an item of expense. The City has conceded this at all times.

The inter-corporate relation growing out of the purchase of the Company's capital stock by Columbia Gas & Electric Corporation did not arise until the early part of 1928 (R. 85). The sole question is whether the City, or Commission, or Court, may as a matter of law (by reason of that relationship) disregard the Company's contract with the United Fuel, and not only require the United Fuel to furnish the quantities of gas as fixed in its contract, but also to furnish in addition all of appellant's requirements in excess of the Owsley County minimum of 750,000 M. c. f. at 12½ cents instead of at the price fixed in its arms'-length contracts. What counsel for the City mean when they reiterate the refrain "When the Owsley gas comes in, the United Fuel goes out," is that after the Owsley County gas comes in the United Fuel gas remains in, plus all additional gas the Company might need, at the arbitrary and inadequate price of 12½ cents per M. c. f.

We do not consider it necessary to argue this proposition. The Court below ignored or overuled the contention as to all gas purchase contracts, and held that the United Fuel contract must be sustained as an arms'-length agreement. We will not therefore burden this Court with a de-

tailed consideration of the City's calculations concerning the cost of gas appearing in its main brief (pages 54, 55, 57-59, 98-100) constructed on the theory of repudiating all gas purchase contracts other than that for the Owsley County gas.

City's Attack on Decision of Trial Court.

The City's reply brief reasserts the right under the doctrine of the *Langnes* case to attack the reasoning and findings of the Court below without taking a cross appeal. We desire to supplement very briefly our contra argument contained in the briefs already filed by appellant.

The City attacks the decree under the guise of upholding it. The entire argument of the City rests upon the proposition that the Court below in refusing to enjoin the Commission rate of 45 cents in effect held such rate to be reasonable. But the decree may not properly be so construed. The City also seeks to have this Court hold that certain specific findings of fact were error. Its contentions may be summarized as follows:

1. The Court fixed the value of the Company's property, the value of the Lexington Utilities property, and the total value of the property allocable to the Lexington District (R. 98). The City seeks to have this Court find these values excessive, but the amount of the alleged excess is left to speculation. The evidence is not here.

2. The Court specifically finds the Commission rate of 45 cents to be confiscatory and invalid (R. 89, 99); and finds a 50 cent rate reasonable, and orders a distribution of the impounded fund on that basis (R. 89, 100). The City attacks the 50 cent rate as excessive and seeks to have this Court find the 45 cent rate reasonable, and that the Court below was in error in holding a 50 cent rate to be reasonable.

3. The Court found the Company was entitled to allowances for amortization and extraordinary maintenance for its own property and also for the Lexington Utilities property, operated under lease, and fixed these allowances (R. 87-88). The City attacks these findings and asks this Court to reverse them.

It seems apparent, therefore, that the City's contention that it is merely seeking to uphold the decree is incorrect. Even if all of the essential evidence were now here, the right of the City to thus attack the decree below without taking a cross-appeal finds no support in any decision of this Court. If the City's contention as to a single one of the alleged errors now pressed upon the Court were sustained, it would necessitate a reversal of the decree.

In addition to the authorities cited in our main brief (pp. 82-84) regarding the right of the appellee to contend the Court below committed error without taking a cross-appeal, we cite the recent case of *Neece* v. *Durst*, 61 F. (2d) 591, 597 (Ninth Circuit), wherein the Court said:

> "* * * we are not considering any of the testimony given by the bankrupt when called by the appellee for cross-examination under the State statute (Code Civ. Proc. Cal., Section 2055), since the lower Court held that 'the special master's ruling in allowing an examination of the husband was erroneous in two respects'. No cross-appeal has been taken in this case, and the Court's ruling must stand."

Due Process

In their reply brief (pp. 5-17) counsel for the City make the same argument on the subject of due process which is made in the original brief; and to which we responded in our reply brief (pp. 27-31).

The principle is well established that a rate for a utility service must stand the test for confiscation in a Court of competent jurisdiction regardless of any machinery that may have been erected by statute providing for hearing before a legislative body or agency. The question must always come to a Court determination *de novo,* as to whether the legislated rate is *in fact* confiscatory.

The argument of counsel for the City is fully and conclusively met in the opinion of the trial Court, rendered in this case with reference to the question of its jurisdiction (37 F. (2d) 938).

VIII.

Response to Brief of Additional Appellees.

The brief filed today on behalf of Mrs. Hignight and others was not received by counsel for appellant until late yesterday (November 5th). We will comment briefly on the following items or subjects discussed therein:

1. *Jurisdiction* (Brief, pp. 3-9). The statutes of Kentucky make no provision for appeal to a State Court from an order of the Railroad Commission fixing rates. (See, Opinion of Statutory Court, R. 68.) Section 201*e*-17 cited by counsel merely regulates the making and enforcement of awards. In such proceedings the validity of a rate cannot be attacked. The only remedy against a confiscatory rate is by an original proceeding in equity for injunctive relief. *L. & N. Railroad Co.* v. *Greenbrier Distillery Co.,* 170 Ky. 775, 786.

2. *Petroleum Exploration Contract* (Brief, pp. 10-12). Section 23 of the Franchis eContract does not require the Company to itself build, own, and maintain the second pipe line as stated by counsel (page 11). The contract provides that the Company shall "begin or cause to have begun * * * the construction of and have in operation or cause to be operated * * * an additional main line * * * to

the distribution system in the City of Lexington; * * *." This requirement was complied with through the contract with Petroleum Exploration for the Owsley County gas, and has been accepted by all parties concerned as full compliance with the provisions of said Section 23.

3. *Amortization* (Brief, p. 19). The fact that neither the statute nor the franchise contract specifically mention amortization is of no significance. The right to such an allowance is a question of law. The proper amount is an issue of fact.

On pages 26-28 counsel quote from the recent decision of the Supreme Court of Ohio in the case of *Columbus Gas & Fuel Co.* v. *Public Utilities Commission*, 127 O. S. 109, which held the Ohio statute did not permit an allowance for amortization. There is no such statute in Kentucky. Furthermore, we understand the Columbus case has been appealed to this Court, and the constitutionality of the Ohio statute remains to be determined.

The remaining matters discussed in this brief have been fully treated in the briefs by appellant.

Conclusion

The evidence establishes that the rates promulgated by the Company are reasonable, and much less than required to yield it even the 7 per cent return which the Court held was fair. The decree should be reversed with directions to enter judgment sustaining the Company's rates.

Respectfully submitted,

HENRY T. DUNCAN,
DYKE L. HAZELRIGG,
CHESTER J. GERKIN,
Counsel for Appellant.

November 6, 1933.